No. 11,796

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

CENTRAL INVESTMENT CORPORATION,
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

BRIEF AMICUS CURIAE.

GEORGE H. KOSTER,
Attorney at Law,
300 Montgomery Street, San Francisco, California,
Amicus Curiae.

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This brief is submitted in support of the proposition that the date fixed by the California Bank and Corporation Franchise Tax Act as the date of accrual of the franchise tax imposed thereunder (which date is also fixed by said statute as the date when a lien for the tax attaches), is the date of accrual of the tax for federal income tax purposes, and the tax is deductible in the year in which that date of accrual falls where the taxpayer keeps its books and files its tax return on an accrual basis of accounting; and the Tax Court erred as a matter of law in the above entitled case in refusing to accept that date as the accrual date and in fixing a different and arbitrary date as the accrual date.

Section 4(7) of the California Bank and Corporation Franchise Tax Act fixes the date of accrual of the tax imposed thereunder as the last day of the "income year" (which is the year on the basis of the income of which the tax is computed); and Sec. 29 of said act provides that a lien for the tax imposed by the act disclosed on the return, shall attach on the last day of the income year upon the real property of the taxpayer.

In this case the Tax Court decided, and we believe the decision to be in error, that the California franchise tax computed on the income of the taxpayer for the year 1943 and imposed on the franchise for the privilege of doing business in 1944 accrued on January 1, 1944, and was an accrued expense for federal tax purposes in 1944 and was deductible in that year rather than in 1943, even though under the California Franchise Tax Act the accrual date and the lien date is fixed as December 31, 1943. The Tax Court described the franchise tax as follows:

> "The franchise tax is imposed for the privilege of doing business during the 'taxable year.' It is true that such tax is measured by the preceding year's income, but it is not an income tax on such income, but rather an excise tax for the privilege of doing business in the 'taxable year' subsequent to the 'income year.' That the tax is essentially a tax on the privilege of doing business in the 'taxable year' is clear from the terms of the act and further from the fact that withdrawal or dissolution relieves the taxpayer from taxation for the period of the 'taxable year' during which the franchise privilege is not exercised."

The determination of the year in which an "accrued expense" is deductible is not something which can be accomplished by mere application of a definite rule or formula. There is no such rule or formula. It is a matter of sound judgment, and yet it is fundamentally a question of law as evidenced by the many cases considered by the Courts involving that question. In this case there is not only the question of—when does the Franchise Tax accrue? but also the question—can the Courts substitute a different time of accrual for this tax than the date specifically fixed in the taxing act as the date of accrual and the date when the lien for the tax attaches? This unquestionably raises a question of law.

Generally, it might be said that an expense accrues ratably over the period to which it applies. For example, if a fire insurance policy is written for a three year period it might be proper to "accrue" the expense of the policy over the three year period; or in the case of interest on a loan it might be proper to "accrue" the interest daily though it may be payable but once a year. The theory behind such "accrual" is that a spread of the expense in such a manner is necessary to reflect the proper income for the respective accounting periods affected by the expense.

But there are cases where the expense is not determinable until a certain date when the events occur which fix the amount and the liability for the tax. In such case the "accrual" of that expense occurs on that date and the expense is atttributable to the year in which that date falls. For example, it has been held

that a munitions tax payable upon income from sale of munitions in a taxable year accrues at the end of the year even though the tax was not assessable or payable until the following year (*U. S. v. Anderson* (1926), 269 U.S. 422, in which the Court recognizes "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of the tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.")

Although this might indicate the possibility of a year-end date as an accrual date of any expense computable on that year's operations, the authorities do not support any such general rule. For example, the federal capital stock tax was an excise tax for the privilege of doing business in a fiscal year July 1 to June 30, and that tax was held to accrue at the *beginning* of the period even though not computable or payable until after the end of the period. (GCM 13681 CB XIV-1 p. 58; *Budd International Corp.,* 45 BTA 737 at 753, in which the Board indicated however that if a different accounting method of accruing this tax were used by the taxpayer it might be acceptable.) It is possible too that only the amount estimated as the ultimate tax is the proper accrual at the beginning of the period and any difference between the estimated and actual tax is accruable at the end of the period. (*U. S. v. Detroit Moulding Corp.* (D.C. Mich. 1944), 56 F. Supp. 754, 32 AFTR 1374.)

In these cases and other similar cases the statute imposing the tax was silent as to the date of accrual

of the tax, so it was necessary to reach out for any logical theory on which to make a determination of the accrual date, with the result that there is no established rule or principle which can be applied to every case, and rules were devised and applied dependent solely upon the judgment of the reviewing Court as to what might be logical and fair in the particular situation. It might well be said that there is no established authority which would bind this Court to any particular conclusion, especially so since this is the first time the question of the time of accrual of the California franchise tax under the Franchise Tax Act as amended in 1943 has come before an Appellate Court. The income tax statute (Sec. 23(c) Internal Revenue Code) provides only that there shall be allowed as a deduction "Taxes paid or accrued within the taxable year". We respectfully submit that it appears logical and fair and therefore lawful, that if the legislature when enacting a tax statute expressly provides for the date of accrual of the tax, that date should be accepted and there should be no occasion for groping around for some theoretical basis for fixing a different date as the accrual date.

The Courts and the Commissioner of Internal Revenue have considered cases involving the accrual date of taxes where the accrual date or the lien date has been fixed by statute. One of the earliest of those cases was the case of *California Sanitary Co. Ltd.* (1935), 32 BTA 122, involving the accrual date of California real property taxes. In that case it was held that California real estate taxes accrue on the first Monday in March, which is the day on which the

lien for the taxes attached, regardless of the fact that the tax is imposed for the period July 1 following the lien date to July 1 of the next year and regardless of the fact too that the tax is not payable until the November following the lien date. In the *Central Investment Corporation* case before this Court the Tax Court says that the *California Sanitary* case is distinguishable because it involved property taxes, the personal liability for which arises by virtue of ownership at a specified time and because the case is authority only for the proposition that a transfer of the property subsequent to the existence of a personal liability for the taxes thereon has no effect on such liability.

The effect of the *California Sanitary* case goes further than indicated by the Tax Court. It is true that in that case an owner of property on the first Monday of March in the tax year transferred the property the following June and the transferee endeavored to deduct the real estate taxes paid by it on that property later in the year, contending that the tax should be held to accrue over the tax year July 1 to July 1 for which it was imposed. The Tax Court held, however, that the tax accrued when it became a lien and that that date must be held to be the date fixed by statute. Under that holding the owner of the property on the first Monday in March is entitled to take the deduction for the full amount of the taxes which became a lien on that date if he keeps his books on an accrual basis. In *Crown Zellerbach Corp.* (1941), 43 BTA 541, appeal dismissed by Stip. CCA-9-1942, the Board in sustaining the Commissioner stated:

> "The respondent takes the lien date of each state —March 1, 1937, in Oregon and Washington, and the first Monday in March, 1937, in California— and, treating the taxes as accrued on that date, *requires the deduction in petitioner's fiscal year ended April 30, 1937, of the year's taxes which accrued on those lien dates in the respective states*" (Italics ours).

See also *Magruder v. Supplee* (1942), 316 U.S. 394, a case somewhat similar to the *California Sanitary* case, and the comment thereon in 1948 Prentice Hall Federal Tax Service, Vol. 2, par. 13123(c) as to its application in determining the deductibility of the tax.

In this case the Tax Court justifies its action in ignoring the accrual date fixed by statute with the following explanation:

> "* * * on the last day of the 'income year' we are unable to see how any liability can arise for a tax imposed on the privilege of doing business for a year not yet commenced. It is true that on the last day of the 'income year' the facts are available which may constitute one of the basic elements of the prospective tax computation and it may also be that then it may seem almost inevitable that some liability will arise by virtue of the next day being the first day of the 'taxable year.' But however inevitable its prospective existence may seem on the last day of the 'income year,' the tax being for the privilege of doing business in the taxable year, the liability therefor arises only with and from the exercise of such privilege. If no business operations were carried

on in the taxable year the tax would not be imposed."

Apart from the Tax Court's difficulty about the fixing of "liability" which is easily answered as will hereinafter be demonstrated, the Tax Court applies a rather extreme test in concluding that the taxpayer might go out of business before January 1, 1944, so might not be subject to tax, and for that reason the tax cannot be held to be accrued until at least the first day of the new year had passed and the taxpayer had done business on that day. This was the theory advanced by the Commissioner in I. T. 3446, CB 1944, page 104, the Commissioner contending that the tax accrues on January 1 of the "taxable" year. The Tax Court makes no mention of what the situation might be if the corporation did no business after January 1. It would be just as much entitled to a refund or abatement of the franchise tax if it dissolved and went out of business on January 2 as it would if it went out of business on midinght of December 31, or on January 1. Certainly the equities or the force of the argument is no stronger in favor of January 1 of the taxable year as an accrual date than the argument in favor of December 31 of the income year as an accrual date. In fact, the argument is not even as strong because there is always the fact that the California Legislature definitely fixed December 31 as the accrual date to support the contention that that is the proper accrual date.

We think the Tax Court might have used a better test, the test of what would generally occur in the

normal course of events. In the normal course of events the corporation will continue in business over the term of its charter and it would seem more practical to presume that it will exercise its privilege of doing business in the taxable year, than to presume that it will not until it actually performs some action on the first day of the taxable year. The Commissioner himself recognizes this "normal course of events test". In GCM 15305 CB XIV-2 p. 80 he considered the time of accrual of a New Jersey real property tax for 1928 assessed against the owner of the property as of October 1, 1927 under the taxing statute. The Commissioner held that the tax accrued on October 1, 1927 the assessment date, and in answer to the contention that the owner on October 1 may not be the person who pays the tax when it is levied at a later date, stated:

> "*In the normal course of events* the owner of real property in New Jersey on October 1 of any given year will pay the taxes levied as of that date. *This is sufficient for the purpose of accrual.* The Bureau's position that liability for real property taxes is incurred by reason of ownership of the property on the day as of which the assessment is made has been sustained by the Board of Appeals in its recent decisions on the subject. (See *Texas Coca Cola Bottling Co. v. Com.* 30 BTA 736 and *California Sanitary Co. Ltd. v. Com.* 32 BTA 122.)" (Italics ours.)

The Commissioner, and to some extent the Courts, have not had too much difficulty in fixing the assessment or lien dates prescribed by the taxing act, as the date of accrual of property taxes for purposes of de-

termining its time of deductibility for federal income tax purposes. (GCM 15305 supra, GCM 21373 CB 1939-2 p. 82; *Crown Zellerbach Corp.,* supra; *Godfrey L. Cabot,* 1939, 40 BTA 366). The franchise tax is an excise tax in the nature of a property tax since it is a tax on the franchise. (*The Pacific Co. Ltd. v. Johnson,* 1932, 285 U.S. 480 affg. 212 Col. 148.)

The answer to the Tax Court's argument that "we are unable to see how any liability can arise for a tax imposed on the privilege of doing business for a year not yet commenced" is obvious. The Tax Court might also have said—we are unable to see *how a lien* can attach for a tax imposed on the privilege of doing business for a year not yet commenced. The same answer applies to both, and that is that the California Franchise Tax Act *fixes the date* of accrual of liability and lien, so that the accrual and lien date for franchise tax based on 1943 income upon the franchise or for the privilege of doing business for the year 1944 is fixed by the Act as December 31, 1943.

If the corporation dissolves or withdraws before January 1, 1944 it is *relieved from payment* of any accrued tax. (Sec. 13(k) of the Franchise Tax Act.) As between the State of California and the taxpayer there can be no question that December 31, 1943 is the accrual and lien date as fixed by the Franchise Tax Act. Just because the Tax Court was "unable to see how" the tax could accrue before January 1, does not justify the Tax Court in substituting its judgment as to what the accrual date ought to be, for that of the California Legislature which specifically fixed the accrual date.

The Tax Court advances the theoretical argument that the tax is an expense attributable to 1944 and that it must be deducted in the year to properly reflect income. As a practical matter, this argument is entirely without foundation. To properly reflect income the tax should be allowed as a deduction in the year upon the income of which it is computed. This was probably the very thing which induced the California Legislature to amend the Franchise Tax Act in 1943 so that taxpayers would get a deduction in the income year, for the franchise tax computed upon that income, and thus be certain of a tax benefit from the deduction.[1] Under the Act before its amendment the accrual date was fixed as the first day of the "taxable year" so the tax on the income of the "income year" was deductible in the following "taxable year" and the possibility of a federal tax benefit from the deduction was dependent upon whether the taxpayer would have adequate income in the following taxable year. In this case the Tax Court ruled that the accrued date of the tax is the same after the amendment as before, and disregards the specific change of the accrual date effected by the amendment.

We respectfully submit that in this case the time of accrual of the franchise tax in determining the period

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[1]Letter from California Franchise Tax Commissioner to Prentice-Hall, Inc. dated Jan. 7, 1944 and reported in Prentice-Hall State and Local Tax Service Vol. 2—Calif.—para. 13062, stating:

> "As to effect of 1943 amendment of Sec. 4(7) of California Bank and Corporation Franchise Tax Act legislature intended to place corporations doing business in California on a current basis for federal tax deduction purposes. As to its effect on 1943 federal returns, this office does not desire to express any opinion * * *"

for which it is deductible for federal tax purposes should be the accrual and lien date fixed by the statute which imposed the tax, which is the last day of the income year. The income year under consideration here is 1943, so the franchise tax computed on the basis of the income for the year 1943 should be allowed as a deduction for federal tax purposes in the year 1943.

Dated, San Francisco, California,
March 18, 1948.

Respectfully submitted,
GEORGE H. KOSTER,
Attorney at Law,
Amicus Curiae.